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Appendix 19

Answer to Purchasing Power Parity Question

A tricky question. Or is it really? Under purchasing power parity (relative form), exchange rates move inversely with inflation rates. Hence, there should be no changes in relative international prices, measured in dollars. Thus, the indexes in year 2 should be the same as in year 1.

The answers are Britain = 150, Japan = 160, Mexico = 80.

Remember: Relative PPP assumes that the price relativities (150, 160, 80) are consistent with currency market equilibrium. It permits predictions of exchange rates, based on inflation rates, precisely because it assumes that the international relativities of prices are fixed.